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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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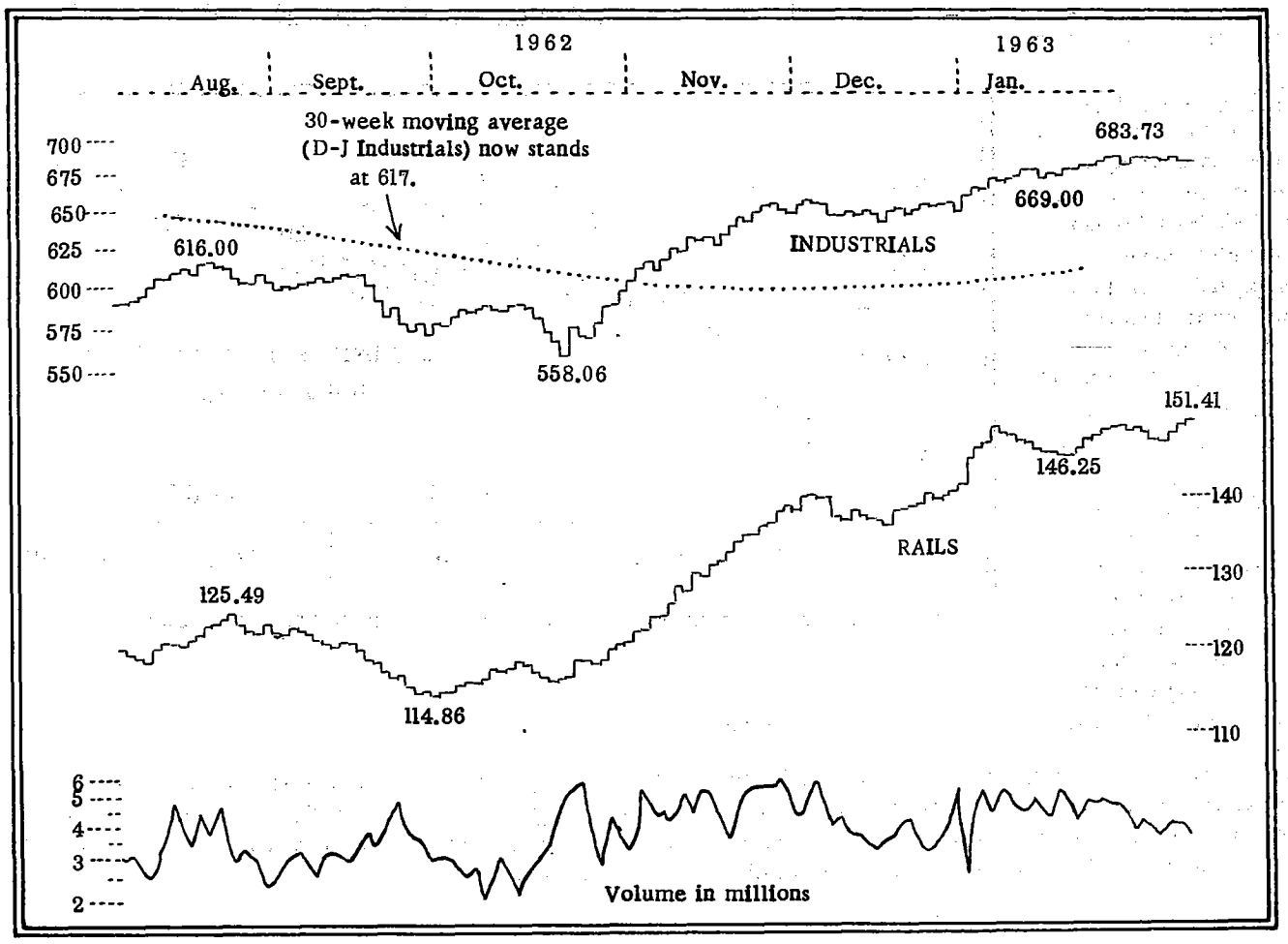
THE MARKET In the nine weeks since December, the market has provided "a little something" for everyone. For the bulls it has continued to push higher with a few "blue chips" (General Motors, duPont, Standard of California, Jersey) leading the way. Bulls can point to the continued odd-lot selling, the good "breadth", and perhaps most of all to the ability of the market to withstand weakness in areas where weakness (via non-confirmation or divergences) might well have developed.

For the bears, the market has also continued to dangle the banner of "hope". Since December, 1962, the advance seems to have lost its real "lifting power". The percentage of rise (as seen on the semi-logarithmic chart on this page) has been slight. The Averages have had trouble staying "in gear" over the past month; moreover, volume has dwindled during those periods when the Averages have plodded upward. The unanimity of bullish professional opinion might also comfort the bears ("the majority of professionals are never right"). Sceptics can also point to the seeming inability of a great many stocks to "move out" of their patterns (stocks break out of formations, rise a few points, then drop back again).

Letter 208 called attention to the rather unconvincing Rail confirmation of January 29. Following that confirmation, Rails immediately backed off -- but Industrials held to the top of their range. On February 6 a new Rail rally began with carriers climbing 1.49 points on the day. February 7 was greeted by news of a stock split and dividend raise for Chrysler. This happy report was accompanied by divergence in the Averages -- Rails rising 82¢ while Industrials dropped 3.43 points.



Thus, the (confusing) process of revolving strength and weakness goes on. The recovery peak on Industrials was established on January 29 at 683.73. If Industrials can better that point with Rails pushing above 150.62, we will have received an "all clear" signal again. Conversely, a breaking of 669.00 (Industrials) and 146.25 (Rails) will imply that the secondary trend has turned down.

TRENDLINES Letter 203 (December 10) discussed the advantages of semi-logarithmic scale as opposed to arithmetic scale for plotting price movements. In general (1) trendlines become more apparent on "log" scale, (2) comparisons of movements in high areas with those in low areas become more meaningful on log scale, and (3) many patterns show more clearly on log scale than on arithmetic scale.

The semi-log scale has the virtue of reducing all movements regardless of price level to a percentage basis. Since investors must deal with percentages of gain or loss, the advantage of log over ratio scale cannot be exaggerated.

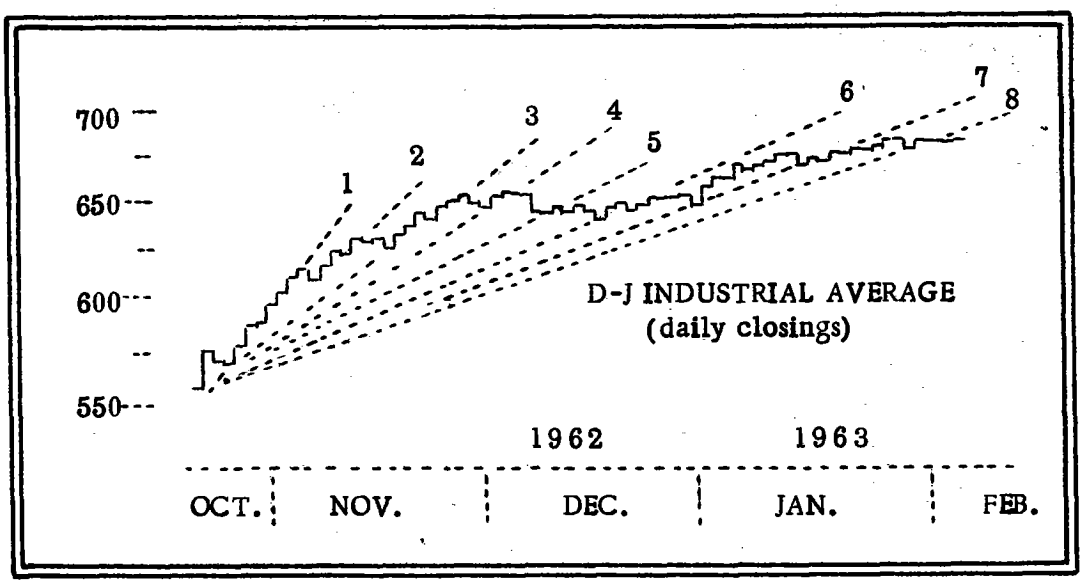
In studying the semi-logarithmic pattern of the Industrial Average since October, 1962 (see chart), a number of factors become apparent through use of the log scale which might not otherwise be noticed. I have drawn a series of rising trendlines, all starting from the October low. These trendlines should be considered as successive rates of upward "thrust". The ability of a price movement to hold to a reasonable rate of rise implies a continuing rate of strength.

Obviously, no price movement (whether it is an Average price movement or an individual stock movement) can be expected to hold persistently to a steep rate of advance. Referring to bull swings and angles of ascent, Edwards and Magee (Technical Analysis of Stock Trends) note: "...it is surprising to see how often the trendline falls very close to the 30 degree slope in stocks of average volatility and activity." In view of this, any market student might have been sceptical of the "lasting ability" of a trendline which began as steeply as that of last October-December (1 and 2 on chart).

Normally a market advance will establish a rising trendline with a reasonable angle of ascent. Industrials will then pull away from the trendline during advances and return to the trendline on minor declines, but the rising trendline will hold intact.

The rise since October, however, has been characterized by a continuous breaking of trendlines or a persistent "flattening" of the rate of rise. Thus, the chart shows that even the shallow trendlines established since December (numbers 5, 6, 7, 8) have been broken during recent action.

CONCLUSION: There is a point at which persistent lack of strength turns into obvious weakness. In the current situation, I feel that a continued violation of successive trendlines (i.e., a continuation of the current action) will shortly lead to a reversal of the upward trend.



SHORT INTEREST RATIO
The S. I. ratio is the ratio obtained by dividing the total short interest on the New York Stock Exchange for any given month by the average daily (trading) volume during that same month. For instance, if there were 5 million listed shorts in February, 1958 and during that same month trading volume averaged 2.5 million shares per day, the S.I. ratio would be 2.0, a very high ratio. It should be born in mind that the greater the total short interest and the lower the average trading volume, the higher the S.I. ratio (and the more bullish the situation).

Every short seller is "playing" for a major market decline. But in order for an important decline to develop, there must be real selling pressure (i.e., declining prices accompanied by heavy downside volume.). Occasionally, after a major decline, the market may turn dull, suggesting that the desire for selling has subsided (and that the market is technically "sold-out"). In such situations, the short seller will find himself under continuing pressure to cover.

One concept should be born in mind, however. As long as the market is breaking into new low ground during a major bear swing, the short interest may be ignored. It is when one or both Averages hold above preceding lows in the face of a large short interest that the short interest assumes a particular importance. This is exactly the situation which occurred last in October, 1962 (see Letter 201). In other words, the market was gathering more and more shorts, but the downside movement had terminated.

The accompanying chart shows the monthly D-J Industrial closings superimposed upon the monthly short interest ratio figures. An examination of the recent history of this relationship should prove worthwhile at this time.

The typical investor tends to hold a rather diversified list of stocks through a bull (or bear) swing. Therefore, it is when the advance-decline ratio (representing the advancing or declining tendencies of the majority of stocks) hits its peak that the average investor finds it most advantageous to sell. Regardless of whether the Industrial Average climbs to further new peaks or not, the A-D ratio peak usually represents the peak of profit potential for the typical investor.

In October, 1957, the Industrial Average and most stocks began the advance which was to be the most profitable of the past decade. For eight months, following the late 1957 bottom, the short interest ratio worked higher! In fact for five incredible months (March through July, 1958) the short interest ratio held in the strongly bullish "over 2.0 area". In August, 1958, the S.I. ratio started down, and eight months later (see chart) the main mass of stocks (as represented by the A-D ratio) recorded their peaks.

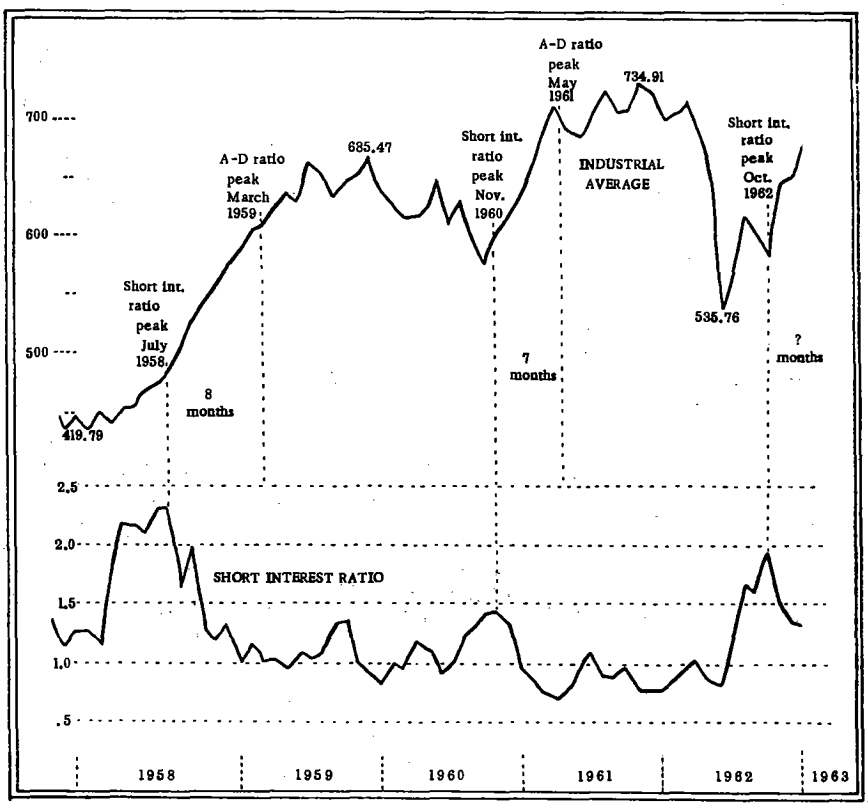
The process was considerably less impressive in 1960. The A-D ratio touched bottom in October of 1960. The short interest ratio recorded apeak during the next month (November at 1.4), then turned down. Seven months later (May, 1961 -- see chart) the A-D ratio "topped out". Thus, the real money was made between October, 1960, and May, 1961.

In the current situation, the advance-decline ratio recorded its low during October, 1962. During that same month the short interest ratio established its peak of 1.98. Since then the market has been rising and the short interest ratio has been declining. Four months have now elapsed since the short interest ratio touched its 1.98 peak.

The important comparisons are as follows: The short interest ratio climbed for eight months against a rising market in 1957-58. When the short interest ratio finally turned down in July, 1958, the advance-decline ratio continued to climb for an additional eight months.

The short interest ratio climbed for only one month against a rising market in 1960. When the short interest ratio turned down in December, 1960, the advance-decline ratio continued to climb for an additional seven months.

The short interest ratio "topped" simultaneously with the beginning of the rise in 1962 (October). As this Letter is written (February, 1963), four months have elapsed since the short interest ratio touched its peak and turned down. Based on past statistics, it is this writer's opinion that the short interest ratio is no longer a bullish consideration as far as the market's technical position is concerned. Moreover, considering that the short interest ratio topped four months ago in October, 1962, the time element for this technical tool is now moving into the neutral to bearish zone.



LATE NOTES (Written Monday, February 11, 11 A.M. N.Y. time): The divergence continued today with Industrials off and Rails at a new recovery high. The first concerted "in gear" movement of the two Averages will probably point the way for the market.

Daily "new highs" touched a 1963 peak of 66 on January 22 (almost three weeks ago). The new high list provides an excellent gauge of upside momentum. Loss of upside momentum does not necessarily imply a reversal to the downside. Nevertheless, unless daily

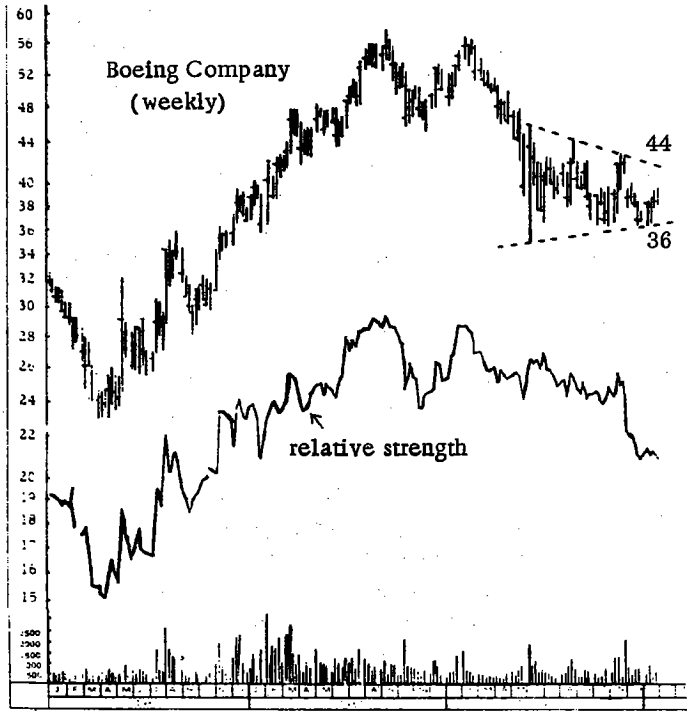
new highs can move significantly above 66 in the near future, I feel that the best market attitude to take is one of increasing caution.

STOCKS Of 350 representative stocks which are tabulated at this office each week, 268 are now holding above their 30-week moving averages (a drop of 2% from last week). Of the same stocks 188 are now above their August, 1962 peak (a drop of 2% from last week).

In the past few Letters I have mentioned the unsatisfactory action of many individual issues. Time after time we have seen a stock (i.e., Case, Brunswick, Kaiser, Lockheed) "break out" of its pattern, hesitate, then fall back. Such action "locks in" new money, discourages new buyers, and is often an advance sign of distribution (we saw this same action during most of 1961).

Since Letter 207 I have had many letters requesting follow-up information on group relative strength. I will include such information in these Letters from now on. As stated in Letter 207, the Auto group remains outstandingly strong on a relative strength basis. Farm equipment continues strong, as does electrical equipment, meat packing and Rails. Oils are losing relative strength, the building and paper groups continue weak, and the aircraft group (shown below) has just broken a major relative strength trendline. Despite the arrival of the "space age", the aircraft group is now showing important weakness. Weakest stocks in this group are General Dynamics, Lockheed and United Aircraft.

One stock which has intrigued me for some time is Boeing Company (chart below). It has formed a hugh symmetrical triangle, a formation which implies that the forces of supply and demand within this issue are in balance. Meanwhile, Boeing's relative strength line has been dropping (since the stock has obviously not kept up with the market). If the stock breaks to 36, it will be in line for shorting; if the stock rises to 44 it will be "a buy."



Charts on this page courtesy of Traders Research, P.O. Box 2466, St. Louis 16, Missouri.